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In Our Opinion...

*The Newsletter of the AICPA Auditing Standards Division**

Volume 4 Number 1

January 1988

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REVISED BANK CONFIRMATION CONSIDERED

The AICPA and the Bank Administration Institute jointly developed the standard bank confirmation form in 1966. Since then, experience has indicated that the form has been ineffective for gathering evidence about the completeness of recorded transactions with banks. Also, banks have been offering a host of new services, which the form was not designed to address. Accordingly, the Auditing Standards Board is considering revising the standard bank confirmation form and developing guidance on how to use it.

Auditors have used the standard bank confirmation form for two purposes. One is to corroborate the client's representations about deposit and loan balances. The other is to search for information the client may not have disclosed to the auditor. In trying to achieve this second purpose, auditors often send confirmation requests that include the client's name but no specific identification of the transactions of interest to the auditor. Because, however, banks often use different systems for processing different types of transactions, the standard bank confirmation has been a less-than-effective tool for achieving this second purpose.

Most financial institutions are organized to readily provide information on an entity's deposit and loan balances. The standard bank confirmation form is generally completed by clerks who work primarily with systems that control the dollar amount of deposit and loans balances. These clerks may be unaware of other transactions about which the auditor seeks information. Banks that do provide information on contingent liabilities, collateral, security agreements, and other transactions expend a great deal of time and cost in doing so. Other banks have begun to issue disclaimers on all items other than requests for deposit and loan balances.

Representatives of the American Bankers Association asked the Auditing Standards Board to consider revising the standard bank confirmation form because financial institutions have not been providing the attention to detail expected by auditors. Furthermore, the peer review process

has identified increasing instances of over-reliance on bank confirmations as audit evidence. These findings demonstrate a need to alert auditors to the risk of placing unwarranted reliance on bank confirmations.

When auditors began using the standard bank confirmation form, the banking laws limited the types of services banks could provide their customers. With deregulation of financial institutions, the number of services and products they can offer has increased dramatically, and many services once offered exclusively by commercial banks are now offered by all types of financial institutions.

With the increase in the number of services provided and in the number of organizations providing these services, proper completion of the standard bank confirmation form has become expensive, difficult, and frequently incomplete.

Because of the identified instances of unwarranted reliance on bank confirmations as audit evidence and the increasing number of complex transactions that financial institutions are developing, the Auditing Standards Board is considering revising the standard bank confirmation form and preparing an auditing interpretation explaining its use.

The Board is considering whether the standard bank confirmation form's purpose should be limited to corroborating information the client has already supplied to the auditor. The Board is also considering guidance to help auditors corroborate the various types of transactions their clients may enter into with banks. One possible approach would be to provide a standard form designed only to request information on deposit and loan balances. Guidance on requesting information about other transactions—such as oral and written guarantees, compensating balance arrangements, letters of credit, and repurchase agreements—would be provided in an auditing interpretation.

The Board plans to publish a revised standard bank confirmation form and an interpretation of SAS No. 31, *Evidential Matter*, in the *Journal of Accountancy* in the first quarter of 1988.

*The views expressed herein are those of the authors and do not necessarily reflect the views of the American Institute of CPAs. Official positions of the AICPA are determined through certain specific committee procedures, due process, and deliberation.

NEW MEMBERS APPOINTED TO ASB

Three new members have been appointed to the Auditing Standards Board. Carl Gross, Gary Holstrum, and John Sullivan replace John Compton, John Ellingsen, and James Loebbecke, whose terms expired on December 31, 1987. At the Board's December meeting, ASB Chairman Jerry Sullivan thanked the outgoing members for their contributions to the Board and welcomed the new members, who are profiled below.

Carl Gross is a partner and the Director of Accounting and Auditing Standards for the Chicago based firm of Altschuler, Melvoin and Glasser. He has served on various committees of both the Illinois CPA Society (ICPAS) and AICPA. He is a past member of the Technical Issues Committee of the AICPA Private Companies Practice Section and the AICPA Accounting and Review Services Committee. He was a member of the Auditing Standards Board's Task Force that developed the standard and guide on prospective financial statements. His past services to the ICPAS include CPE Council, Long Range Planning Task Force and Chairman of the Accounting Principles Committee. He is currently a member of the ICPAS Professional Standards Restructure Communication Task Force. He has recently been appointed to the *Journal of Accountancy's* Board of Consultants.

Gary Holstrum is the Peat Marwick Professor of Accounting at the University of Central Florida. Prior to joining the Central Florida faculty, he was a Professor of Accounting at the University of Southern California. From 1978 to 1983, Gary was a Partner in Auditing Services in the executive office of Deloitte Haskins and Sells. Before that, he was on the faculties of the University of Florida and the University of Texas at Austin. He did his doctoral work at the University of Iowa.

Professor Holstrum was the 1985-86 Chairman of the Auditing Section of the American Accounting Association. His writings have appeared in *The Journal of Accountancy*, *Auditing: A Journal of Practice and Theory*, *The Accounting Review*, *The Journal of Accounting Research*, *Advances in Accounting*, *Management Accounting*, *The Internal Auditor*, and other journals.

John Sullivan is in the executive office of Deloitte Haskins & Sells. He is the Partner in Charge of the Auditing Services Department, which is responsible for his firm's auditing policies and procedures. Mr. Sullivan joined his firm's Houston office in 1973. He was a client service partner in that office of the firm until 1987, when he moved to the executive office to assume his present responsibilities. He received his BBA degree from the University of Houston.

TECHNICAL PLAN HIGHLIGHTS

"EXPECTATION GAP" PROJECTS

On February 14, 1987 the Board issued exposure drafts of nine proposed SASs and one proposed attestation standard. At its November and December 1987 meetings, the Board voted to ballot on final issuance of nine of these proposed SASs (See "How a Standard is Approved" on page 4.) These new SASs will become effective for periods ending on or after January 1, 1989 (except as discussed below). Here is a summary of the status of each of these proposed standards.

The Auditor's Responsibility to Detect and Report Errors and Irregularities (AICPA Staff: JANE MANCINO). In December 1987 the Board voted to ballot on final issuance of this SAS, which will supersede SAS No. 16, *The Independent Auditor's Responsibility for the Detection of Errors or Irregularities*. It will require the auditor to design the audit to provide reasonable assurance of detecting material misstatements. It also discusses matters that may indicate a risk of material misstatements, indicates how to respond to those matters, and emphasizes the importance of professional skepticism. It will require the auditor to be assured that the audit committee is adequately informed of irregularities. *Schedule*: Final SAS to be issued first quarter 1988.

Illegal Acts by Clients (JANE MANCINO). In December 1987 the Board voted to ballot on final issuance of this SAS, which will supersede SAS No. 17 of the same title. It will define the auditor's responsibility for detecting illegal acts that could have a direct and material effect on financial statement amounts as being the same as that for detecting errors and irregularities. This responsibility is greater than the auditor's responsibility for other illegal acts, which do not have a direct effect on financial statement amounts but could result in loss contingencies. Also, this SAS will require the auditor to determine that the audit committee is adequately informed of detected illegal acts. *Schedule*: Final SAS to be issued first quarter 1988.

Examination of Management's Discussion and Analysis (MIMI BLANCO). This proposed attestation standard would provide guidance to auditors engaged to attest to management's discussion and analysis (MD&A), thereby enhancing the credibility of that information to users. *Schedule*: The Board has deferred further work on this proposed standard pending the SEC's decision on its concept release on MD&A. The Board expects to finalize the standard in 1988.

Communications with Audit Committees or Others with Equivalent Authority and Responsibility (MIMI BLANCO). In December 1987 the Board voted to ballot on final issuance of this SAS, which will require auditors to ensure that persons responsible for oversight of auditing and financial reporting (such as audit committees) are informed about certain matters related to the conduct of an audit. Those matters include significant accounting policies, accounting estimates, the significance of audit adjustments, and disagreements with management. The SAS will apply to audits of public entities and of all other entities having either an audit committee or another group formally assigned responsibility for overseeing financial reporting. *Schedule*: Final SAS to be issued first quarter 1988.

The Auditor's Standard Report (MIMI BLANCO). In December of 1987 the Board voted to ballot on final issuance of this SAS, which is intended to help financial statement users better understand the auditor's role. It will require the auditor's standard report to explicitly address the responsibility auditors assume, the procedures they perform, and the assurances they provide. This new SAS will also revise the second standard of reporting by requiring the auditor's report to address consistency only when accounting principles have not been consistently applied. *Schedule*: Final SAS to be issued first quarter 1988.

(continued on page 3)

TECHNICAL PLAN HIGHLIGHTS (continued from page 2)

Auditing Accounting Estimates (MARK BEASLEY.) In November 1987 the Board voted to ballot on final issuance of this SAS, which describes procedures an auditor may consider in evaluating the reasonableness of accounting estimates. It also identifies internal control structure elements that may reduce the likelihood of material misstatements of estimates. *Schedule:* Final SAS to be issued first quarter of 1988.

The Auditor's Responsibility for Assessing Control Risk (PEG FAGAN). In December 1987 the Board voted to ballot on final issuance of this SAS, which will supersede AU section 320, *The Auditor's Study and Evaluation of Internal Control*. This SAS will broaden the auditor's responsibility to study and evaluate internal control when planning an audit and will incorporate the concepts of audit evidence and audit risk. The Board has revised the exposure draft to incorporate specific concepts in AU section 320, not originally included in the proposed SAS, and clarify terminology in the proposed SAS. *Schedule:* Final SAS expected to be issued second quarter of 1988. This proposed SAS would be effective for periods ending on or after December 15, 1989.

The Communication of Internal Control-Structure Related Matters Noted in an Audit (ANTHONY DALESSIO). In November 1987 the Board voted to ballot on final issuance of this SAS, which will supersede SAS No. 20, *Required Communication of Material Weaknesses in Internal Control*, and sections of SAS No. 30, *Reporting on Internal Accounting Control*. This new SAS will require auditors to report "reportable conditions." The concept of reportable conditions is broader than and encompasses material weaknesses in internal control. This SAS will also prescribe a form of written communication of reportable conditions designed to be clearer than the report on internal control presented in SAS No. 30. *Schedule:* Final SAS to be issued first quarter 1988.

The Auditor's Consideration of an Entity's Ability to Continue in Existence (PEG FAGAN). In December 1987 the Board voted to ballot on final issuance of this SAS, which will supersede SAS No. 34, *The Auditor's Consideration When a Question Arises About an Entity's Continued Existence*. This SAS will require the auditor to consider continued existence of an entity in all engagements. Furthermore, the SAS will eliminate the "subject to" opinion qualification but will require the auditor to modify his report when substantial doubt exists about an entity's ability to continue in existence. The SAS describes an entity as a going concern if it is able to meet its obligations and continue in operations. *Schedule:* Final SAS to be issued first quarter of 1988.

Analytical Procedures (PEG FAGAN). In November 1987 the Board voted to ballot on final issuance of this SAS, which will supersede SAS No. 23, *Analytical Review Procedures*, and will require the use of analytical procedures in the planning and final review stage of all audit engagements. It also provides guidance on the development and use of analytical procedures as well as on evaluating their effectiveness and efficiency in detecting errors and irregularities. *Schedule:* Final SAS to be issued first quarter 1988.

OTHER PROJECTS

Here is a summary of the status of the Auditing Standards Division's other projects.

Financial Forecasts and Projections (MIMI BLANCO). The Auditing Standards Board created the Forecasts and Projections Task Force to deal with problems encountered in implementing the guidance in the Statement on Standards for Accountant's Services on Prospective Financial Statements. Persons with questions or problems in this area are urged to write to the task force, care of the Auditing Standards Division, at the AICPA (1211 Avenue of the Americas, New York, NY 10036).

Reporting on Examination of Pro Forma Adjustments (JANE MANCINO). The Board has developed an attestation standard that provides guidance on reporting on pro forma adjustments. That guidance includes concepts presented in the 1984 exposure draft of a proposed SAS on this subject. The Board has added guidance on reviews of pro forma adjustments. *Schedule:* Standard to be issued early 1988.

Omnibus SAS-1987 (MARK BEASLEY). In November 1987 the Board voted to ballot on final issuance of the proposed SAS *Omnibus Statement on Auditing Standards-1987*. This proposed SAS contains amendments to SAS No. 5, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles" in the Independent Auditor's Report*, SAS No. 27, *Supplementary Information Required by the FASB*, and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. The amendments recognize the GASB's authority to establish financial accounting principles for state and local governmental entities pursuant to Rule 203 of the AICPA's Code of Professional Ethics and standards on disclosure of financial information for such entities under Rule 204. It also would revise existing standards in response to FASB Statement No. 89, *Financial Reporting and Changing Prices*. It would rescind SAS Nos. 28, *Supplementary Information on the Effects of Changing Prices*, SAS No. 40, *Supplementary Mineral Reserve Information*, and SAS No. 45, *Supplementary Oil and Gas Reserve Information*, with the guidance in SAS No. 45 being reissued as an auditing interpretation. *Schedule:* Final SAS to be issued first quarter 1988.

Revision of Standard Bank Confirmation Form (MARK BEASLEY). The Auditing Standards Division is considering an interpretation of SAS No. 31, *Evidential Matter*, that would present a new standard bank confirmation form and provide guidance on when to use the form and when to request information through separate correspondence with bank officials. *Schedule:* The auditing interpretation and revised bank confirmation form are expected to appear in the *Journal of Accountancy* in the second quarter 1988.

Compliance Auditing (PATRICK MCNAMEE). In December 1987 the Board voted to ballot on issuance of an exposure draft of a proposed SAS that would provide guidance on the auditor's responsibility in an engagement to report on compliance with laws and regulatory requirements of government financial assistance programs. *Schedule:* Exposure draft to be issued first quarter 1988.

HOW A STANDARD IS APPROVED

At its November and December meetings, the ASB voted to ballot on nine final SASs and one exposure draft. (See "Technical Plan Highlights" on page 2.) Voting to ballot is just the first step in the six-to-eight-week process of reviewing and approving a final SAS or an exposure draft. Here is a summary of how a proposed SAS is reviewed and approved before it is published.

- ASB votes to ballot on a final SAS or exposure draft.
- ASB Chairman, task force chairman, AICPA's legal counsel, and the Vice President, Auditing, review the proposed

or final SAS and approve it for balloting.

- ASB members read the approved ballot draft and indicate their votes on a written ballot. Fourteen affirmative votes from among the twenty-one board members are needed to issue an SAS or exposure draft.
- ASB Chairman, task force chairman, AICPA's legal counsel, and the Vice President, Auditing, perform a final review of the proposed or final SAS and give final approval to publish it.

RECENT DIVISION PUBLICATIONS

In the January 15, 1988 issue of the "CPA Letter," the Auditing Standards Division issued a notice to practitioners providing guidance on the independent auditor's standard report in view of FASB Statement No. 95, *Statement of Cash*

Flows. This Notice supersedes guidance recommended by the ASB's planning subcommittee in the "CPA Letter" dated November 16, 1987.

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